93-404

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether Section 12(2) of the Securities Act of 1933 is applicable to a privately negotiated resale of all the stock of a corporation.

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Petitioners, Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this proceeding on June 11, 1993.

OPINIONS BELOW

The order of the United States Court of Appeals for the Seventh Circuit is not reported. It is included in the Appendix hereto at App. 1. The opinion of the United States District Court for the Northern District of Illinois is also not reported. It is included in the Appendix hereto at App. 3.

JURISDICTIONAL STATEMENT

Invoking federal jurisdiction under 28 U.S.C. §1331, Respondents brought suit under Section 12(2) of the Securities Act of 1933, 15 U.S.C. §77l(2) ("Section 12(2)"), in the United States District Court for the Northern District of Illinois. On May 29, 1992, the district court, ruling that Section 12(2) does not apply to the transaction at issue, granted Petitioners' motion for summary judgment.

On Respondents' appeal, the United States Court of Appeals for the Seventh Circuit, on June 11, 1993, entered a judgment ordering the district court's order vacated and remanding this case to the district court for further proceedings in light of the Seventh Circuit's opinion in *Pacific Dunlop Holdings Inc. v. Allen & Co. Inc.*, 993 F.2d 578 (7th Cir. 1993) (holding Section 12(2) applies to secondary market transactions), *petition for cert. filed*, 62 U.S.L.W. 3144 (U.S. Aug. 24, 1993) (No. 93-201). No petition for rehearing was sought.

This petition for certiorari is filed within 90 days of the Seventh Circuit's June 11, 1993, judgment. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTE INVOLVED

This case involves Section 12(2) of the Securities Act of 1933, 15 U.S.C. §77l, which provides as follows:

Civil Liabilities Arising in Connection
With Prospectuses and
Communications

Sec. 12. Any person who—

(1) offers or sells a security in violation of section 5, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

STATEMENT OF THE CASE

This case arises out of the December 1989 sale of the stock of Alloyd Co., Inc. ("Alloyd") pursuant to a privately negotiated stock purchase agreement (the "Agreement"). Respondents ("Buyers") claim that material misrepresentations were made in connection with the sale in violation of Section 12(2) and in breach of the Agreement.

Alloyd is a manufacturer of clear plastic blister packaging and automatic heat seal packaging equipment. Alloyd's stock has been outstanding since 1961. In 1989, Arthur L. Gustafson ("Gustafson"), Daniel R. McLean ("McLean"), and Francis I. Butler ("Butler") (collectively "Sellers") were Alloyd's sole shareholders. In the spring of 1989, KPMG Peat Marwick ("KPMG") was retained to find a buyer for Sellers' Alloyd stock. A "Profile" was distributed to prospective buyers providing extensive information relating to Alloyd, including historical and budgeted financial information. The Profile stated that the budgeted 1989 information was unaudited and that "the actual results achieved may vary from the prospective financial results and the variations could be material."

A copy of the Profile was sent to Respondent, Wind Point Partners II, L.P. ("Wind Point"), an experienced and sophisticated venture capital investment partnership. Wind Point visited Alloyd's facilities and reviewed extensive additional information relating to Alloyd.

In October, 1989, Sellers agreed in principle to sell their Alloyd stock to Alloyd Holdings, Inc. ("Holdings), a corporation to be formed by Wind Point to effectuate the purchase. McLean and Butler agreed to invest about $1,500,000 for a minority interest in Holdings and become officers and directors.

While negotiating the Agreement, Wind Point conducted extensive due diligence. KPMG was retained by Wind Point to conduct a business review of Alloyd and perform other procedures relating to Alloyd's interim financial statements. The interim financial statements included estimated components consistent with Alloyd's historical performance affecting Alloyd's cost of goods sold and, thus, gross profit. KPMG informed Wind Point in writing that:

> Because of the size of the accounting/finance staff of the company, there is limited in-house analysis of the financial results on either a monthly or yearly basis. As a result, significant adjustments to the financial statements are typically made by the external accounting firm at year-end.

KPMG's report to Wind Point detailed how Alloyd adjusted its inventory at year-end when an actual audit occurred, stating that "Alloyd's year-end adjustments to inventory have been material in past years."

Alloyd's estimated inventory was discussed extensively during Wind Point's due diligence. Wind Point knew that Alloyd had an unreliable inventory control system and that the only way to determine Alloyd's actual inventory would be to take a physical inventory. KPMG told Wind Point that without an audit or inventory count there would be no way of knowing how large Alloyd's inventory adjustment would be at year-end. Wind Point decided not to take a physical inventory or conduct an audit prior to the closing on the sale. Buyers decided to close the transaction without an audit or physical inventory, paying an estimated purchase price at closing to be adjusted after an audit of Alloyd's year-end financial statements.

Sellers' representations in the Agreement regarding Alloyd's interim financial statements were carefully negotiated and modified in drafts of the Agreement. Early language stating that Alloyd's interim financial statements presented Alloyd's financial condition "accurately and completely", was revised in the final Agreement to state that the interim financial statements "present fairly" Alloyd's financial condition. The final Agreement added a specific reference to notes to Alloyd's unaudited interim financial statements, which notes stated that inventory and certain accrued expenses were estimated and subject to adjustment at year-end.

The Agreement was executed as of December 20, 1989, and the transaction closed on December 22, 1989, when Holdings purchased Sellers' stock for $18,709,000 plus a payment of $2,122,219 reflecting an estimate of Alloyd's increase in net worth from December 31, 1988, through the closing. The Agreement required that Sellers or Buyers remit an appropriate amount to cover any variance between the estimated increase in net worth and the actual increase after the year-end audit of Alloyd's financial statements. After KPMG took a physical inventory as part of its audit of Alloyd's December 31, 1989 financial statements, Sellers paid Holdings $815,000 plus interest to cover the difference between the estimated amount paid at the closing and the actual amount due pursuant to the Agreement.

On February 11, 1991, Buyers instituted this case alleging that Sellers misrepresented Alloyd's interim financial condition in violation of Section 12(2) and that Sellers breached the Agreement.

The district court's May 29, 1992 Memorandum Opinion and Order granted Sellers' motion for summary judgment

as to Buyers' Section 12(2) claim, noting that the Alloyd securities involved in this transaction had been outstanding for approximately 30 years, the sale of the securities was a negotiated resale to a single buyer, and Wind Point was an experienced investor with direct access to information regarding Alloyd. The court concluded that Section 12(2) did not apply because the transaction was not an initial distribution and did not possess the characteristics of an initial offering. In doing so, the court agreed with the Third Circuit's analysis in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3rd Cir.) *cert. denied*, 112 U.S. 79 (1991), which had held that:

> In sum, the language and legislative history of section 12(2), as well as its relationships to Sections 17(a) and 10(b) within the scheme of the 1933 and 1934 Acts, compel our conclusion that Section 12(2) applies only to initial offerings and not to aftermarket trading.

When Buyers appealed to the Seventh Circuit, briefing and argument was held in abeyance pending resolution of the appeal in *Pacific Dunlop Holdings Inc. v. Allen & Co. Inc., supra*. After reversing the district court in *Pacific Dunlop*, the Seventh Circuit, on June 11, 1993, vacated without opinion the district court's Order in this case and remanded the case for further consideration in light of *Pacific Dunlop*. Petitioners appeal from that judgment of the Seventh Circuit.

REASONS FOR GRANTING THE WRIT

Review by writ of certiorari is a matter of judicial discretion which should be favorably exercised as to a substantial question of federal law when a conflict exists between or among United States Courts of Appeals which creates confusion among the lower courts. *See Insurance Corp. of Ireland v. Compagnie des Bauxites*, 456 U.S. 694, 700 (1982); *United States v. Lorenzetti*, 467 U.S. 167, 173 (1984); *McElroy v. United States*, 455 U.S. 642, 643 (1982). This case meets these requirements.

I.

Whether Section 12(2) Applies To Privately Negotiated Secondary Transactions Is A Substantial Question Of Federal Law.

Section 12(2) is a unique provision in the securities laws which provides that buyers of securities may, if sellers make an unintentional misrepresentation by means of a prospectus, rescind the transaction. The cause of action created by Section 12(2) is more akin to one for negligent misrepresentation than to fraud covered by Section 17 of the 1933 Act (15 U.S.C. §77q) and Section 10(b) of the 1934 Act (15 U.S.C. 78j(b)) and Rule 10b-5 thereunder (17 C.F.R. §240.10b-5 (1992)). Indeed, courts have concluded that material misrepresentations render sellers "strictly liable" under Section 12(2). *Capri v. Murphy*, 856 F.2d 473, 478 (2d Cir. 1988).

Privately negotiated secondary market transactions with sophisticated buyers typically involve extensive due diligence, negotiation with regard to representations and warranties, and allocation of risks frequently associated with the transaction. Whether, notwithstanding such due diligence, negotiation, and allocation of risk, Section 12(2) allows buyers to rescind based on an unintentional misrepresentation is a matter of critical importance to the negotiation and structuring of such transactions.

This Court has previously acknowledged the importance of certainty in application of the federal securities laws, stating: "uncertainties attending the applicability of the Acts would hardly be in the best interest of either party to a transaction." *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 696 (1985). As discussed below, the Seventh and Third Circuits are in conflict on the question presented by this petition and uncertainty will continue to exist in circuits which have not addressed the question.

The transaction at issue here involved the resale of long-issued stock to sophisticated buyers pursuant to a negotiated agreement to close without a physical inventory or audited financial statements using an estimated purchase price to be adjusted after an audit. If Sellers breached the Agreement, Buyers have a remedy under the Agreement. The important question of federal law which prompts this petition is whether sellers in this type of transaction are also liable for rescission or rescissionary damages under the strict liability rationale of Section 12(2).

The trial court and the Third Circuit held Section 12(2) does not apply to this type of secondary transaction. In *Pacific Dunlop*, the Seventh Circuit ruled that Section 12(2) applies to all secondary market transactions. Which interpretation is correct is of critical importance affecting thousands of negotiated transactions annually, because certainty will permit contracting parties to determine requisite due diligence and allocate risk by agreement. This Court should grant certiorari to resolve the important question of federal law presented in this case.

II.

Direct Conflicts Exist Among Numerous Courts Regarding This Question.

In *Ballay*, the Third Circuit held that Section 12(2) applies only to initial distributions, not to aftermarket trading, based on "the language and legislative history of Section 12(2), as well as its relationships to Sections 17(a) and 10(b) within the scheme of the 1933 and 1934 Acts." *Ballay*, 925 F.2d at 693.

The Seventh Circuit in *Pacific Dunlop* held that Section 12(2) applies to secondary market transactions in addition to initial offerings, acknowledging that its holding was squarely at odds with that of the Third Circuit in *Ballay*: "[W]e depart from the Third Circuit and hold that Section 12(2) includes secondary market transactions." 993 F.2d at 582. Plainly, an irreconcilable conflict exists between these Circuit Courts.

Other circuits also have, by implication, addressed this issue with conflicting and confusing results. In *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D. N.Y. 1977), *aff'd mem.*, 636 F.2d 1201 (2d Cir. 1980), the court affirmed the district court's dismissal of a Section 12(2) claim based on a secondary market transaction because Section 12(2) only protects purchasers of stock sold pursuant to a misleading prospectus, which the court found is only used with respect to an initial offering. In contrast, in *Cady v. Murphy*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940), the court upheld a Section 12(2) claim where the sale involved outstanding stock, though neither the parties nor the court directly addressed whether Section 12(2) applies solely to initial offerings. Similarly, in *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959), the court, although not directly addressing whether 12(2) ap-

plies solely to initial offerings, upheld a Section 12(2) claim where the securities were sold in a secondary transaction.

The applicability of Section 12(2) to secondary market transactions has been inconsistently addressed by at least 30 reported district court opinions. The substantial majority of these opinions favor limiting Section 12(2) to initial distributions, utilizing numerous rationales to reach this conclusion.[1] Other courts have concluded to the contrary, permitting application of Section 12(2) to secondary

[1] *Bogart v. Shearson Lehman Bros., Inc.*, 1993 U.S. Dist. LEXIS 1182 (S.D.N.Y. 1993); *Budget Rent A Car Systems, Inc. v. Hirsch*, 810 F. Supp. 1253 (S.D. Fla. 1992); *Comeau v. Rupp*, 810 F. Supp. 1127 (D. Kan. 1992); *Hedden v. Marinelli*, 796 F. Supp. 432 (N.D. Cal. 1992); *Newman v. Comprehensive Care Corp.*, 794 F. Supp. 1513 (D. Or. 1992); *In re Delmarva Securities Litigation*, 794 F. Supp. 1293 (D. Del. 1992); *Bennett v. Bally Mfg. Corp.*, 785 F. Supp. 559 (D.S.C. 1992); *Professional Serv. Indus., Inc. v. Kimbrell*, 1992 WL 403639 (D. Kan. 1992); *Cox v. Eichler*, 765 F. Supp. 601 (N.D. Cal. 1990); *Bank of Denver v. Southeastern Capital Group, Inc.*, 763 F. Supp. 1552 (D. Colo. 1991); *T. Rowe Price New Horizons Fund, Inc. v. Preletz*, 749 F. Supp. 705 (D. Md. 1990); *Grinsell v. Kidder, Peabody & Co.*, 744 F. Supp. 931 (N.D. Cal. 1990); *Leonard v. Stuart-James Co.*, 742 F. Supp. 653 (N.D. Ga. 1990); *Mix v. E.F. Hutton & Co.*, 720 F. Supp. 8 (D.D.C. 1989); *First Union Brokerage v. Milos*, 717 F. Supp. 1519 (S.D. Fla. 1989); *McCowan v. Dean Witter Reynolds, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,423 (S.D.N.Y. Apr. 11, 1989); *Cheltenham Bank v. Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,391 (E.D.N.C. Feb. 15, 1989); *Strong v. Paine Webber, Inc.*, 700 F. Supp. 4 (S.D.N.Y. 1988); *Ralph v. Prudential-Bache Sec. Inc.*, 692 F. Supp. 1322 (S.D. Fla. 1988); *Leonard v. Shearson Lehman/Am. Express, Inc.*, 687 F. Supp. 177 (E.D. Pa. 1988); *SSH Co. v. Shearson Lehman Bros., Inc.*, 678 F. Supp. 1055 (S.D.N.Y. 1987); *Ackerman v. Clinical Data, Inc.*, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶92,207 (S.D.N.Y. July 8, 1985); *Klein v. Computer Devices*, 591 F. Supp. 270 (S.D.N.Y. 1984), *clarified on reh'g*, 602 F. Supp. 837 (S.D.N.Y. 1985); *Gross v. Diversified Mortgage Investors*, *supra*.

market transactions under various rationales.[2] Securities law scholars and commentators also disagree as to whether Section 12(2) applies to secondary market transactions in addition to initial distributions.[3]

Certiorari should be granted, in light of these numerous conflicts, to resolve this important question.

III.

The Decision of the District Court Should be Reinstated.

Section 12(2) only provides a remedy against "Any person who offers or sells a security . . . by means of a prospectus or oral communication. . . ."[4] The district court's

[2] *PPM Am., Inc. v. Marriott Corp.*, 1993 U.S. Dist. LEXIS 5914 (D. Md. 1993); *Farley v. Baird, Patrick & Co.*, 750 F. Supp. 1209 (S.D.N.Y. 1990); *Folger Adam Co. v. PMI Indus., Inc.*, 1990 U.S. Dist LEXIS 3349 (S.D.N.Y. 1990); *In re Ramtek Securities Litigation*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,483 (N.D. Cal. Sept. 7, 1990); *Elysian Fed. Sav. Bank v. First Interregional Equity Corp.*, 713 F. Supp. 737 (D.N.J. 1989) (overruled by *Ballay*); *Wilko v. Swan*, 127 F. Supp. 55 (S.D.N.Y. 1955).

[3] *Compare* Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1 (1992), and Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97 (1991), *with* Loss, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev. 908 (1992), and Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Post Distribution Markets*, 32 Wm. & Mary L. Rev. 847 (1991).

[4] The term "oral communication" does not broaden the meaning of "prospectus" or the application of Section 12(2) to secondary market transactions. While the 1933 Act does not define "oral communication," judicial interpretation has properly restricted the term to oral communications relating to or connected with a prospectus. *Pacific Dunlop*, 993 F.2d at 588; *Ballay*, 925 F.2d at 688. *See also Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 8 (1985) (words grouped in a list are given related meaning).

holding that Section 12(2) does not afford a remedy to Buyers as to this privately negotiated transaction is in accord with the plain meaning of Section 12(2), which, by its use of "prospectus", does not connote a negotiated private resale of securities. The Agreement here does not comport with any obvious interpretation of the word "prospectus". It was not a communication device designed to entice buyers. Rather, the Agreement set forth the negotiated terms upon which the purchase would take place.

That Section 12(2) should not be read expansively to apply to the transaction at issue here is confirmed by the primary purpose of the 1933 Act, the legislative history attendant to its adoption, the structure of the 1933 Act and the additional remedies afforded by the 1934 Act. "The primary purpose of the 1933 Act was the regulation of the distribution of securities. Post-distribution trading is regulated by the 1934 Act." L. Loss, *Fundamentals of Securities Regulation*, 92 (1983). "The 1933 Act is . . . chiefly concerned with disclosure and fraud in connection with offerings of securities primarily, as here, initial distributions of newly issued stock from corporate issuers." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975). *See also Pinter v. Dahl*, 486 U.S. 622, 638 (1988) (primary purpose of the 1933 Act is protection of investors through disclosure allowing informed investment decisions concerning public offerings of securities).

The House Report accompanying the 1933 Act stated this primary purpose in the clearest terms:

> The bill affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering. . . .

H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933). As to the civil liability provisions of Sections 11 and 12 of the 1933 Act in particular, the Report stated:

> The committee emphasizes that these liabilities attach only when there has been an untrue statement of material fact or an omission to state a material fact in the registration statement or the prospectus—the basic information by which the public is solicited.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

Consideration of Section 12(2) in the context of the other provisions of the 1933 Act also demonstrates that, by its use of the word "prospectus", Section 12(2) applies only to transactions taking on the characteristics of an initial offering. The provisions of 1933 Act are primarily concerned with requiring and regulating disclosure in two documents—registration statements and prospectuses. Under Section 5 (15 U.S.C. §77e) a person may not, absent an appropriate exemption, offer or sell a security by means of a prospectus without filing a registration statement. *See A.C. Frost & Co. v. Coeur D'Alene Mines Corp.*, 312 U.S. 38, 41-42 (1941). Accordingly, the phrase "by means of a prospectus" has meaning in the 1933 Act primarily in the context of a distribution of securities pursuant to a registration statement.[5] Sections 5 through 7 (15 U.S.C. §§77e-g) detail the contents and proper use of a registration statement and the related prospectus in connection

[5] The term "prospectus" appears forty-two (42) times in the text of the 1933 Act. While Section 2(10) defines broadly the various forms which a prospectus may take, it does not change the fact that fundamentally a prospectus is a document "which offers any security for sale or confirms the sale of any security" after a registration statement is filed. 15 U.S.C. §77b(10).

with such a distribution and Section 10 (15 U.S.C. §77j) sets forth the information required in the prospectus.

The remedial provisions in the 1933 Act are Sections 11, 12 and 17. Section 12(2) must be read in the context of its placement in the 1933 Act and in comparison to the Act's other remedial provisions. *Dole v. United Steel Workers of America*, 494 U.S. 26, 36 (1990). Section 11 (15 U.S.C. §77k) provides for civil liability on account of false registration statements. Section 12 provides for civil liability arising in connection with prospectuses and communications. Section 12(1) provides a remedy where the seller violates the solicitation and sale requirements of Section 5 and Section 12(2) provides a remedy when a person offering or selling a security makes a misrepresentation "by means of a prospectus or oral communication". Section 12(1)'s direct reference to the registration requirement of Section 5 makes clear that Section 12 is focused on remedying abuses in the initial distribution process. Given its position in the same section and particularly its use of "prospectus", Section 12(2) cannot reasonably be construed as applicable to secondary transactions while the closely related Section 12(1) plainly applies only to initial distributions.

In contrast to Sections 11 and 12, Section 17(a) of the 1933 Act is phrased broadly proscribing fraud in the offer or sales of any securities in language which differs significantly greatly from the specific phrase "offers or sells . . . by means of a prospectus or oral communication" used in Section 12(2). In *United States v. Naftalin*, 441 U.S. 768, 777-778 (1979), the Court observed that: "Unlike much of the rest of the Act, [Section 17(a)] was intended to cover any fraudulent scheme in the offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading."

Unlike the legislative history of Section 12(2), the legislative history of Section 17(a) explicitly demonstrates an intention to apply that Section to transactions in both the primary and secondary securities market. "The act subjects the sale of old or outstanding securities to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation as in the case of new issues . . . ." S. Rep. No. 47, 73d Cong., 1st Sess. 4 (1933).

That Sections 11 and 12 apply only to initial distributions is also evidenced by the fact that both sections provide a remedy only to a buyer. This is consistent with the Act's primary purpose since the prospectus and registration statement are selling documents prepared by the seller. In the context of initial distributions, the provision of a remedy for misled buyers and the absence of any remedy for misled sellers makes complete sense because only buyers can be injured by misrepresentations in an initial distribution context. In contrast, in a negotiated private resale, there are representations and warranties by buyers and sellers. It makes no sense, in such a transaction, for a buyer to have available the extraordinary remedy of rescission while sellers are granted no remedy as to the same transaction.

A buyer can recover under Section 12(2) simply by showing that the seller misstated or failed to state a material fact. The buyer need not prove scienter, reliance or loss causation. *See, e.g., Ballay*, 925 F.2d at 689 (negligent misrepresentation is actionable under Section 12(2)); *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir. 1989) (proof of scienter or loss causation is not required by Section 12(2)); *Capri v. Murphy*, 856 at 478 (material misrepresentation renders sellers strictly liable under Section 12(2)).

The extension of Section 12(2) and its much less stringent standards of liability to all secondary transactions would afford all buyers, and only buyers, a remedy which effectively renders superfluous, whenever a buyer sues, Rule 10b-5 and years of precedent with respect to scienter, reliance, and loss causation under that Rule. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (under Section 10(b) plaintiff must establish, *inter alia*, that defendant acted recklessly or with an intent to deceive known as scienter); *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981) (Section 10(b) imposes upon the plaintiff a stringent reliance requirement), *cert. denied*, 455 U.S. 938 (1982); *Sims v. Faestel*, 638 F. Supp. 1281 (E.D. Pa. 1986) (plaintiff in Section 10(b) claim must establish direct causal relationship between alleged misrepresentation and loss), *aff'd*, 813 F.2d 399 (3d Cir. 1987).

The different remedies available under Section 12(2) and Section 10(b) further support the conclusion that Section 12(2) is limited to initial distributions. Section 12(2) provides for rescission or rescissionary damages, *see Pinter v. Dahl, supra*, while Section 10(b) permits recovery only of actual damages. *See Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). A seller in an initial distribution should bear liability for rescission or rescissionary damages because the seller receives the full purchase price from the buyer and is the buyer's sole source of information concerning the value, risk, and quality of the security. The rescission remedy without scienter, reliance, or causation proof afforded by Section 12(2) is consistent with the congressional purpose of regulating and promoting full disclosure in initial distributions by forcing disgorgement of the entire amount the seller received irrespective of the damages actually suffered by the buyer. The same is not true in a privately negotiated secondary

market transaction where the buyer has independent market information, access to the seller's financial and operational records, and the ability to negotiate the terms of the acquisition and allocate risks by agreement. In such transactions, the remedy should be limited to the actual loss sustained, the remedy afforded by Section 10(b) of the 1934 Act and Rule 10b-5. Application of Section 12(2) to all secondary market transactions would undermine this proper allocation of remedies.

In sum, the language of Section 12(2), the purpose and structure of the 1933 Act, the legislative history of the Act and Section 12(2) and the interplay between the 1933 Act and the 1934 Act all demonstrate that Section 12(2) was not intended to apply to a privately negotiated resale of stock.

IV.

The Seventh Circuit's Broad Application of Section 12(2) is Not Warranted by its Language or the Structure or Purpose of the 1933 Act.

In *Ballay*, the court observed that "Congress repeatedly used the term 'prospectus' in provisions concerning registration statement requirements in initial distributions." 925 F.2d at 689. Pursuant to this analysis, the Third Circuit held "Congress employed the term 'prospectus' as a term of art which describes the transmittal of information concerning the sale of a security in an initial distribution." *Id.* at 688. As the Third Circuit observed, if Congress had intended a more expansive meaning for Section 12(2), it "more simply could have drafted Section 12 to describe all written or oral communications." *Id.* at 689. Congress' use of the more restrictive phrase "by means of a prospectus" evidences convincingly its intent that the phrase was not intended to encompass privately negotiated resale transactions.

The Seventh Circuit in *Pacific Dunlop* relied almost exclusively on the broad definition of "prospectus" in Section 2(10) of the Act to conclude "Section 2(10) is broad enough to include initial and secondary market transactions." 993 F.2d at 588. The court recognized the general rule that a person could not offer or sell a security by means of a prospectus without filing a registration statement and that "[t]his would imply that a prospectus cannot exist without a registration statement." *Id.* at 586. Notwithstanding this plainly proper implication, the court effectively ruled that every sale of securities involves some written or oral communication, so every sale of securities is covered by Section 12(2).

Unlike the Third Circuit, the Seventh Circuit failed to properly analyze the plain meaning of the words used in Section 12(2) particularly in light of the primary purpose of the Act, its structure, and the legislative intent to limit the applicability of Section 12(2) to initial offerings.

The Seventh Circuit failed to consider properly the significant distinction between a prospectus and a stock purchase agreement, a commonly used device for transferring a large block of shares in a privately negotiated transaction. The former is a "single party document"—prepared by the issuer or proponent of the initial offering as a selling device to the public. It is a disclosure and sales tool, prepared without the prospective buyers' input or investigation. The flow of information is one-sided and the incentive to "puff" is great, thereby justifying the protection of, and unique remedy provided by, Section 12(2). In contrast, a stock purchase agreement is a "two-party document"—prepared jointly and negotiated by the buyer and seller. It is not used to solicit the transaction. It merely documents the jointly agreed upon terms of the parties after investigation by the buyer. Such a two-party docu-

ment is not a "prospectus" as referenced in Section 12(2) given the primary objectives of the 1933 Act.

In addressing the legislative history, the Seventh Circuit in *Pacific Dunlop*, 993 F.2d at 589-92, relied primarily on a negative inference from minor revisions in the wording of Section 12(2) and the *lack* of expressed intent as to the scope of the Section in the Senate and Conference Reports, to conclude that secondary market transactions are covered by Section 12(2).

> In the face of the Senate's broad wording, that civil fraud applies to any sale, the commentary by the House's managers remained silent. Although the legislative history in the House report can be read to focus solely on those offerings pursuant to a registration statement and prospectus (or in the Third Circuit's words, to initial offerings), the Senate's version of the 1933 Act and the conference report do not confirm the House's comments.

Id. at 592.

Nor, however, did the Senate's version or Conference Report negate or conflict with the House's comments. As acknowledged by the Seventh Circuit, "[t]he Senate rarely mentioned the word 'prospectus' and certainly not in the fraud context of Section 12(2). And the Senate, as compared to the House, did not draft as detailed a report in support of the bill." *Id.* at 591. Nonetheless, the court relied improperly on general language or silence by the Senate to negate—without really addressing—the explicit House Report, which emphasized that Section 11 and 12 liabilities attached only to untrue statements "in the registration statement or the prospectus—the basic information by which the public is solicited." H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

The Seventh Circuit's expansive conclusion that Section 12(2) applies to secondary transactions constitutes an unreasonably broad construction of that Section not warranted by its language, the primary purpose and structure of the Act or the Act's legislative history.

CONCLUSION

The district court below and the Third Circuit in *Ballay* correctly concluded that Section 12(2) does not apply to privately negotiated secondary market transactions that do not resemble an initial offering of securities. The Seventh Circuit's broader interpretation in *Pacific Dunlop* should be rejected. A writ of certiorari should issue to review the judgment of the Court of Appeals for the Seventh Circuit vacating the trial court's judgment in Petitioners' favor.

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

June 11, 1993

Before

Hon. WILLIAM J. BAUER, Chief Judge
Hon. FRANK H. EASTERBROOK, Circuit Judge
Hon. MICHAEL S. KANNE, Circuit Judge

ALLOYD COMPANY, INCORPORATED, formerly known as ALLOYD HOLDINGS, INCORPORATED, a Delaware Corporation, and WIND POINT PARTNERS II, L.P., a Delaware Limited Partnership,

Plaintiffs-Appellants,

No. 92-2514 v.

ARTHUR L. GUSTAFSON, DANIEL R. MCLEAN and FRANCIS I. BUTLER,

Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 91 C 889—Ann Claire Williams, Judge.

This matter comes before the court for its consideration of the following documents:

1. MOTION TO VACATE JUDGMENT AND REMAND TO DISTRICT COURT filed herein on 5/19/93, by counsel for the appellants.

2. DEFENDANTS-APPELLEES' RESPONSE TO PLAINTIFFS-APPELLANTS' MOTION TO VACATE JUDGMENT AND REMAND TO DISTRICT COURT filed herein on 5/28/93, by counsel.

3. PLAINTIFFS-APPELLANTS' MOTION TO FILE REPLY IN SUPPORT OF THEIR MOTION TO VACATE AND REMAND filed herein on 6/2/93, by counsel.

On consideration thereof,

IT IS ORDERED that the Plaintiffs-Appellants' Motion to File Reply in Support of their Motion to Vacate and Remand is DENIED as unnecessary. The judgment of the lower court is VACATED and the this case is REMANDED to the district court for further proceedings in light of this court's opinion in *Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc.*, No. 91-2346 (7th Cir. May 7, 1993).

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Case No. 91 C 889

ALLOYD CO., INC., et al.,

Plaintiffs,

v.

ARTHUR L. GUSTAFSON, et al.,

Defendants.

MEMORANDUM OPINION AND ORDER

Plaintiffs Alloyd Co., Inc., formerly known as Alloyd Holdings, Inc. ("Holdings") and Wind Point Partners II ("Wind Point") brought this suit against defendants Arthur Gustafson ("Gustafson"), Daniel McLean ("McLean"), and Francis Butler ("Butler"). The plaintiffs claim that the defendants made material misrepresentations when selling all their stock in Alloyd, Inc. ("Alloyd") to them in violation of Section 12(2) of the Securities Exchange Act of 1933 ("Section 12(2)") and in breach of the pertinent stock purchase agreement (the "Agreement"). The parties subsequently brought cross-motions for summary judgment. For the reasons stated below, the court grants defendants' motion for summary judgment and denies plaintiffs' motion as moot.

Background

In 1989, Gustafson, McLean and Butler were the sole shareholders of Alloyd, a manufacturer of clear plastic blister packaging and automatic heat seal packaging equipment. After deciding to sell the company, Alloyd engaged KPMG Peat Marwick ("KPMG") to find a buyer. In the course of soliciting purchasers, KPMG prepared a "profile" describing the company to distribute to parties expressing serious interest in purchasing Alloyd. A copy of this profile was sent to Wind Point.

On August 11, 1989, Wind Point submitted a letter summarizing its interest in Alloyd. Wind Point representatives were then invited to visit Alloyd's physical plant. By October 17, 1989, Alloyd agreed to sell substantially all of its issued and outstanding stock to Holdings, a new corporation to be formed by Wind Point to effectuate the sale of Alloyd. Holdings was subsequently incorporated on November 17, 1989 with McLean and Butler serving as its officers and directors, and Wind Point, McLean, Butler, Carl Lutz, William Lord, and Henry Young as its shareholders.

While negotiating the terms of the Agreement, Wind Point conducted extensive due diligence regarding Alloyd. KPMG also conducted a formal business review of Alloyd and performed other procedures relating to Alloyd's financial statements. KPMG was to report on Alloyd's inventory as well as other aspects of the company's financial performance. Of particular interest to this case, KPMG provided inventory information based upon estimates of the costs of goods sold and gross profits. KPMG could only provide estimates because Alloyd only took inventory at the end of each year. Although the appropriateness of taking a physical inventory was discussed, no physical audit was taken prior to closing on the sale.

At the closing on December 20, 1989, Holdings acquired Alloyd's stock for $18,709,000 plus $2,122,219 to reflect the estimated adjustment amount of Alloyd's earnings. The Agreement signed by Alloyd and Holdings set forth detailed procedures to be followed after the year-end audit was conducted to remit the appropriate amount should the audit disclose a variance between Alloyd's estimated and actual earnings for that year.

By February 8, 1990, McLean determined that Alloyd's actual 1989 earnings and year-end net book value were significantly less than the estimates relied upon to determine Holding's payment of the estimated adjustment amount. This variance was attributed to the fact that Alloyd's year-end inventory was significantly lower than estimated. After confirming the discrepancy, McLean met with Richard Kracum, a general partner of Wind Point and a director of Holdings, and other Wind Point employees to inform them of the shortfall in Alloyd's inventory. On February 11, 1991, the plaintiffs instituted the instant law suit. Pursuant to the adjustment provision in the Agreement, on March 11, 1991, the defendants repaid $815,000 plus interest to Holdings to cover the difference between the estimated adjustment amount paid by Holdings at the closing and the actual adjustment amount due as determined by Alloyd's year-end audit.

The Cross Motions for Summary Judgment

Summary judgment is appropriate when the pleadings and discovery show that "there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56. The moving party bears the initial burden of establishing that no genuine issues of material fact exist. *Celotex Corp.*

v. Catrett, 477 U.S. 317, 321-22 (1986). The nonmoving party must respond to the moving party's claims by establishing specific facts that demonstrate a genuine issue that must be resolved at trial. *Id.* When assessing a motion for summary judgment, the court must accept as true the nonmoving party's evidence and draw all legitimate inferences in the nonmoving party's favor. *Valentine v. Joliet Township High School District*, 802 F.2d 981, 986 (7th Cir. 1986).

In their motion for summary judgment, the defendants raise several procedural arguments which they claim bar the plaintiffs from bringing this law suit. The defendants contend that Wind Point lacks standing to sue under Section 12(2) because it was not a purchaser of the securities at issue. Wind Point counters that it was the actual purchaser of Alloyd because it was the party who negotiated the purchase of Alloyd's stock and created Holdings for the sole purpose of consummating the sale.

Generally, only purchasers have standing to sue for violations of Section 12(2). *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 789-91 (8th Cir. 1967); *Dyer v. Eastern Trust and Banking Co.*, 336 F. Supp. 890, 910 (D. Me. 1971). Several courts have addressed the question of whether a party who creates a shell corporation to purchase another entity constitutes a purchaser for the purposes of establishing standing. The plaintiffs contend that this court should follow the court's decision in *H.B. Holdings Corp. v. Scovill Inc.* where the court determined that the plaintiff, who had established a shell corporation to purchase the defendant corporation, qualified as a purchaser with standing to sue under Section 12(2). 1990 LW 37869 (S.D. N.Y. March 26, 1990). In *Scovill*, the court noted that the defendant understood that the plaintiff was the purchaser, the defendants had solicited the plaintiff as a purchaser

before the shell corporation was created, the plaintiff submitted the bid that the defendant accepted, and after closing, the plaintiff was in control of the shell corporation. The court concluded that this evidence sufficiently established that the plaintiff was the actual party at risk in the transaction and therefore had standing to sue. *Id.*

This court is persuaded by the court's reasoning in *Scovill*. To hold that plaintiffs who are and were treated by all parties as the actual purchasers do not have standing merely because they did not sign the pertinent sale agreement would be to put form over substance. Although Wind Point did not sign the Agreement in this case, like the plaintiff in *Scovill*, Wind Point was the actual party at risk in the pertinent transaction and was treated as such by all involved parties. For example, before Holdings was created, Wind Point obtained a profile of Alloyd, inspected Alloyd's facilities, and sent a letter of interest to Alloyd. The defendants even acknowledged that in November 1991, they agreed with Wind Point to form a corporation to buy Alloyd. Furthermore, during the course of negotiations over the purchase price, Wind Point conducted due diligence. Then, when the defendants subsequently determined that the inventory estimates they had relied upon to establish a purchase price for Alloyd were inaccurate, they contacted Wind Point employees to inform them of the discrepancy. These facts establish that Wind Point was and the defendants recognized Wind Point as the actual purchaser of Alloyd.

This determination also comports with the Tenth Circuit's decision in *Grubb v. Federal Deposit Insurance Corp.*, 868 F.2d 1151 (10th Cir. 1989). In *Grubb*, the plaintiff and the director of Security National Bank ("SNB") formed a shell corporation to purchase all the shares of SNB from the First National Bank and Trust Company of Oklahoma

City ("First National"). In determining that the plaintiff had standing to sue under the Securities Exchange Act,[1] the court noted that the defendant seller made misrepresentations during direct negotiations with the plaintiff, negotiations occurred before the shell corporation was even established, and the shell corporation was created for the sole purpose of facilitating the purchase. *Id.* at 1161-62. The court also noted that the plaintiff had personally guaranteed the shell corporation's loan to purchase the SNB. *Id.* The *Grubb* court's reliance on the facts that the defendant recognized the plaintiff as the purchaser and the plaintiff was the actual party at risk supports this court's determination that Wind Point has standing in the instant law suit.

The defendants suggest that this court should rely instead upon the court's determination in *Rayman v. Peoples Savings Corp.*, 735 F. Supp. 842 (N.D. Ill. 1990). In *Rayman*, Peoples Savings Corporation ("PSC") created a shell corporation to purchase Peoples Bank of Savings. The Flanagans were principal shareholders of PSC. The question before the court was whether the Flanagans had standing to bring a counterclaim under Section 10(b) of the Securities Act. *Id.* at 844-45. Based upon the court's thorough consideration of the policies underlying Section 10(b), the court determined that it must employ a bright-line definition of a purchaser when determining whether a claimant has standing. *Id.* at 848. Since the court found

[1] The *Grubb* court was faced with the question of whether the plaintiff had standing to sue under Section 10(b) of the Securities Exchange Act. The *Grubb* court's analysis is still applicable to the instant action because the same requirement that the plaintiff be a purchaser of the pertinent stocks arises under Section 10(b) as it does under Section 12(2).

that shareholders do not qualify as purchasers, it held that the Flanagans did not have standing to sue under Section 10(b). *Id.* at 851.

Contrary to the defendants' suggestion, this court declines to follow *Rayman*. This court finds that the *Rayman* court's reliance upon a strict, bright-line definition of a purchaser appears to conflict with the Seventh Circuit's analysis in *Norris v. Wirtz*. 719 F.2d 256 (7th Cir. 1983). In *Norris*, the Seventh Circuit determined that the plaintiff, the beneficiary of a trust which had sold certain stocks, had standing to sue under Section 10(b) and Rule 10b-5 of the Securities Exchange Act. In reaching this conclusion the court stated: "The broad proscription against fraud set forth in Section 10(b) and Rule 10b-5 is defeated in its remedial purposes by taking an unrealistic view of what is alleged to have happened in this case." *Id.* at 260 (citing *Herman & MacLean v. Huddleston*, 103 S.Ct. 683 (1983)). This statement, as well as the court's determination that the plaintiff beneficiary had standing to sue, suggests that the Seventh Circuit did not intend to employ a strict definition of who constitutes a purchaser as the court in *Rayman* suggests.[2]

This court also declines to follow *Rayman* because we are not persuaded that the policy analysis relied upon in *Rayman* court is applicable to the instant law suit. As

[2] The Seventh Circuit also stated that to grant standing to the plaintiff in this case would not threaten the concerns addressed by the standing requirement for Section 10(b) and Rule 10b-5. *Norris*, 719 F.2d at 259. Indeed, in support of this contention, the court cited *James v. Gerber Products Co.* for the proposition that "the courts have generally inclined to a logical and flexible construction of the term 'purchaser-seller' in order to accommodate the avowed purpose of § 10(b) of protecting the investing public and of ensuring honest dealings in securities transactions." *Id.*

previously stated, the *Rayman* court based its determination that a bright-line rule should be employed upon its analysis of the policy considerations underlying Section 10(b). *See* 735 F. Supp. at 848. The defendants in this case have provided this court with no evidence suggesting that the policy concerns underlying Section 10(b) are identical to those under Section 12(2) or are otherwise relevant to this court's determination. Therefore, this court finds that Wind Point has standing to sue under Section 12(2).[3]

The defendants next contend that the plaintiffs' claims are timebarred. Section 13 of the Securities Exchange Act of 1933 requires plaintiffs to bring claims under Section 12(2) within "one year after the discovery of the untrue statement or omission, or after such discovery should have been made by the exercise of reasonable diligence." *DeBruyne v. Equitable Life Assurance Society of the United States*, 920 F.2d 457, 466 (7th Cir. 1990).

[3] The fact that Wind point was not the only shareholder of Holdings also does not affect this court's conclusion that Wind Point has standing to sue under Section 12(2). This court recognizes that the court in *City National Bank of Fort Smith, Arkansas v. Vanderboom* considered the fact that the plaintiffs were not the sole shareholders of the pertinent shell corporation when determining that the plaintiffs did not have standing to sue under Section 10(b). 422 F.2d 221 (8th Cir. 1970). However, this court is not persuaded that the fact that there were several shareholders in Holdings other than Wind Point should prevent Wind Point from establishing standing in the instant case. In this case, Wind Point was the majority shareholder of Holdings and the other shareholders consisted of four of the five key management personnel from Alloyd. *See* Defendants' Statement of Material Facts at ¶¶ 17-18; Defendants' Motion for Summary Judgment at 5. The defendants also acknowledge that they intended to sell Alloyd to Holdings, "a company to be formed by Wind Point." Defendants' Statement of Material Facts at ¶ 15. In addition, unlike in *Vanderboom*, other evidence in this case suggests that Holdings was a conduit formed to purchase Alloyd. *See Id.* at 228.

The parties agree that on February 8, 1990, McLean, now the President of Holdings, became aware of the shortfall in Alloyd's inventory. The parties also agree that McLean did not inform other officers of Holdings of the shortfall until February 12, 1990. The defendants contend that McLean's discovery of the discrepancy on February 8 started the running of the one year limitations period in this case. The plaintiffs counter that the statute of limitations period did not begin to run until February 12 when other Holdings officers learned about the inventory shortfall.

Generally, a principal is charged with the knowledge of its agent acquired in the course of the principal's business. *First National Bank of Cicero v. Lewco Securities Corp.*, 860 F.2d 1407, 1417 (7th Cir. 1988). However, an exception to this rule has been carved out in cases where the agent's interests are shown to be adverse to those of his principal. *Id.* In such cases, it is presumed that such an agent is unlikely to fulfill his fiduciary duty of full disclosure to the principal. *Id.*; Restatement (Second) of Agency § 282(1); *Evanston Bank v. ContiCommodity Services, Inc.*, 623 F. Supp. 1014, 1036 (N.D. Ill. 1985).

Contrary to the defendants' suggestion, even though McLean had become the President of Holdings and Alloyd no longer existed, this court finds that McLean's interests were adverse to those of Holdings. As evidenced by the present case, the inventory shortfall at issue could result in McLean being held liable to Holdings. McLean could therefore have had a personal interest in not telling the other Holding officers about the shortfall. Since McLean's interests were adverse to Holdings, the knowledge he acquired about the shortfall on February 8, 1990 cannot be imputed to Holdings. The statute of limitations period began to run in this case on February 12, 1990, the date

when other Holdings officers learned about the discrepancy. Since the plaintiffs filed their complaint on February 11, 1991, one day before the limitations period ran out, the plaintiffs' Section 12(2) claim is not time-barred as the defendants suggest.

The defendants further contend that the plaintiffs' Section 12(2) claim should be dismissed because this provision can only be applied to initial offerings. Although the case law is divided, the trend favors limiting Section 12(2) actions to purchasers in initial offerings. *See, e.g., Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991); *Pacific Dunlop Holdings, Inc. v. Allen & Company Inc.*, 1991 U.S. Dist. LEXIS 6748 (N.D. Ill. 1991); *Bank of Denver v. Southeastern Capital Group, Inc.*, 763 F. Supp. 1552 (D. Co. 1991); *T. Rowe Price New Horizons Fund, Inc. v. Preletz*, 749 F. Supp. 705 (D. Md. 1990); *Grinsell v. Kidder, Peabody, & Co.*, 744 F. Supp. 931 (N.D. Ca. 1990).

This court is persuaded, most notably by the Third Circuit in *Ballay*, that Section 12(2) claims can only arise out of the initial stock offerings. *See* 925 F.2d 682. In a thorough and well-reasoned opinion, the *Ballay* court determined that the language and legislative history of Section 12(2), as well as its relationship to Section 17(a) and 10(b) within the schemes of the 1933 and 1934 Acts, compelled a finding that Section 12(2) only applies to initial offerings and not to after-market trading. *Id.* at 693. The one other court in this district faced with this issue has also agreed with the Third Circuit's analysis. *See Pacific Dunlop Holdings*, 1991 U.S. Dist. LEXIS 6748. Based upon the court's reasoning in *Ballay*, this court therefore concludes that application of Section 12(2) must be restricted to initial distributions.

As the plaintiffs argue, the legislative history of the 1933 Securities Exchange Act suggests that Section 12(2) can be applied to a redistribution of securities if "such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering." H.R. No. 85, 73d Cong., 1st Sess. 7 (1933); *Ballay*, 925 F.2d at 690. While the plaintiffs suggest that this language supports their argument that Section 12(2) is applicable, they have provided this court with no evidence to support their claim that the sale at issue possesses the characteristics of a new offering. At most, the plaintiffs claim that the instant case involved the purchase of stock directly from the controlling shareholders rather than from a stockbroker as was the case in *Ballay*. This claim does not suffice to overcome the court's conclusion that Section 12(2) cannot be applied to this case because other evidence more strongly suggests that the transaction at issue in this case cannot be compared to an initial offering. For example, the parties agree that Alloyd was formed in 1961. *See* Defendants' Statement of Material Facts at ¶ 2. Hence, the transaction at issue in this case occurred approximately 30 years after the initial issuance of Alloyd's stock. *See Bank of Denver*, 763 F. Supp. at 1559. Also, unlike purchasers in most initial offerings, the purchasers in this case had direct access to financial and other company documents, and had the opportunity to inspect the seller's property.

Since the plaintiffs fail to provide this court with adequate evidence showing that the pertinent transaction is not comparable to an initial offering, this court finds that Section 12(2) cannot be applied to the instant case. The court therefore grants defendants' motion to dismiss plain-

tiffs' Section 12(2) claim.[4] The court also dismisses plaintiffs' state law breach of contract claim for lack of jurisdiction. Finally, the court denies plaintiffs' motion for summary judgment as moot.

Conclusion

For the reasons stated above, the court grants defendants' motion for summary judgment and denies plaintiffs' motion for summary judgment as moot.

ENTER:

____

Ann Claire Williams, Judge
United States District Court

Dated: May 29, 1992

[4] The defendant also contends that the plaintiffs cannot prove the substantive elements of a Section 12(2) claim. There is no need for this court to consider this argument since, upon review of the defendants' arguments, the court finds that these arguments will not affect our decision to grant defendants' motion for summary judgment because the plaintiffs cannot bring a claim under Section 12(2).